Faculty Working Papers

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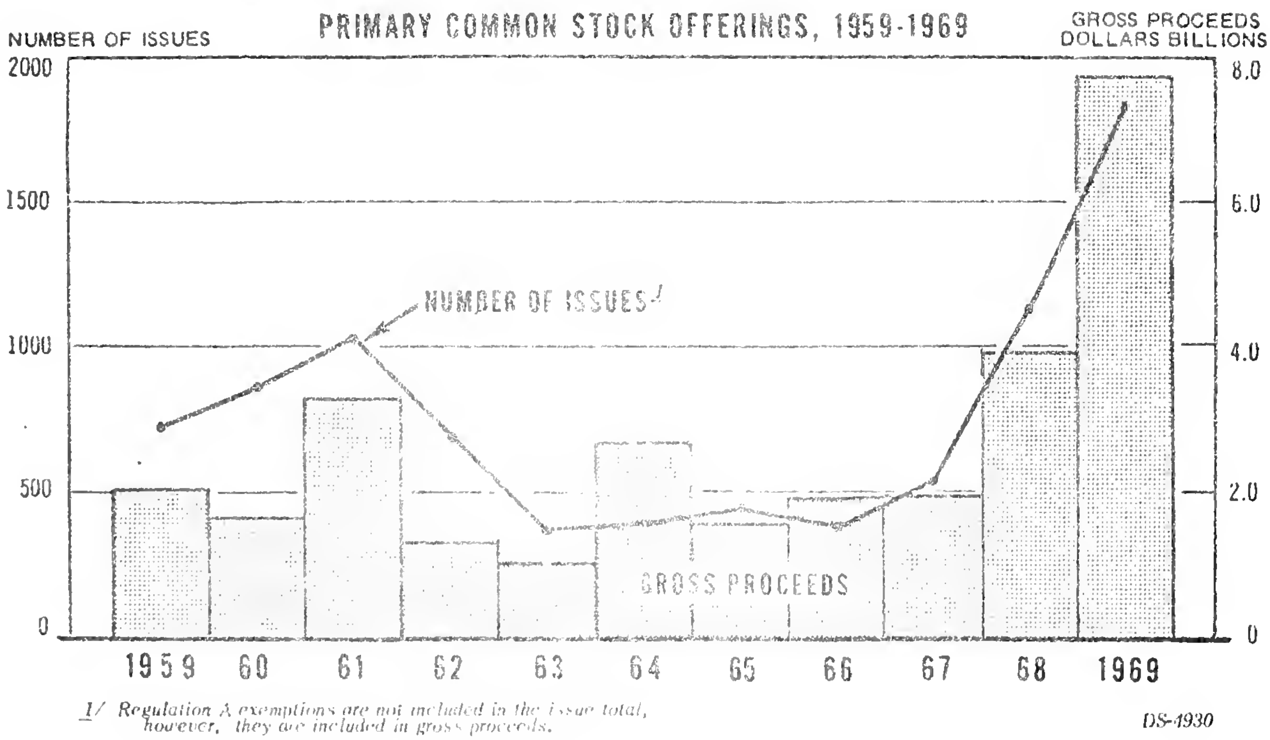
The decade of the 1960's saw a marked cyclical pattern to the number of new common stock issues. Within the ten year period peaks occurred in 1961, 1965, and 1969. (See Figure 1) The highest levels of common stock registrations by dollar amounts occurred in 1961, 1964, and 1969. The cyclical pattern of common stock issuances followed very closely the overall economic developments of the period, and were similar to the performance of the major stock market indexes such as the Dow-Jones Industrial Average.

FIGURE 1



[1]U. S., Securities and Exchange Commission, New Securities Offered For Cash Sale, 1969, Statistical Series, Release No. 2420, February 4, 1970.

The large number of new common stock issues during the 1960's placed heavy demands upon the investment banking community in its role as a fund raiser. Through the process of underwriting, in its many forms, the issuing firms obtained necessary capital funds and investors were given the opportunity to share in hopefully profitable enterprises. The financial intermediary, or "middleman" between these two groups, the investment banker, provided a wide range of services that included financial advice, short-term credit, and "after-market" participation.

The range of compensation received by the investment banker is almost as broad as the services he provides for his customers and clients. The focal point of the present study is non-cash compensation, sometimes referred to as "extra" compensation. The term "extra" refers to the fact that this type of compensation, when used, is normally in addition to cash compensation in the form of discounts and commissions on the number of shares purchased by the underwriter. Other forms of compensation received by the investment banker may include accountable or non-accountable expense allowances, commissions on the restricted sale of a certain number of shares to management and employees, and the right of first refusal on subsequent offerings by the issuer.

"Extra compensation may take a number of forms. The most common type is a warrant to purchase shares of the issuing firm at a particular price for a specified period of time. Options may also be granted by the issuing firm, or in some cases by selling shareholders, to the underwriter permitting him to purchase shares of the company at a particular price. Finally, the sale of "cheap stock" to the underwriter, at a price less than the public offering price, may also be an indirect form of compensation. Each of these devices provides some form of equity participation for the underwriter in the future performance of the company, or at least in the future performance of its share price. The underwriter is given an opportunity to earn amounts in addition to those received immediately for his underwriting services.

The use of these forms of extra compensation may actually influence the amount of cash compensation paid to the underwriter. Where an investment banker feels that the risks are so high in a particular underwriting as to make cash compensation too high a percentage of the gross offering, he may substitute non-cash compensation and lower his discounts from the public offering price. The National Association of Securities Dealers(NASD) performs the function of determining just when compensation levels are excessive.

The incidence of extra compensation as a means of paying for underwriting services is particularly high among new issues of common stock of companies that are selling stock to the public for the first time. These are normally small companies, often recently organized, and for whom an issue of common stock is practically the only means of obtaining additional long-term capital at the time.

Obviously, many of these fledgling firms require the full range of services provided by the investment banker. They also represent the class of securities that involves the greatest degree of risk to the underwriter, the risk that once purchased, these securities cannot be sold at a profit. These are only two of several reasons why investment bankers who concentrate in the area of new issues feel that extra compensation is justified or even necessary to the performance of their function. They see themselves as operating in a different risk-return environment than those underwriters who handle only seasoned issues of well-known corporations.

The area of non-cash compensation has been explored by several research studies into securities markets and the investment banking community. The two most prominent of these studies were those of the Special Study of Securities Markets by the Securities and Exchange Commission[2] and the study of the New Issues market by the Wharton School of Finance and

Commerce.[3] Limited studies of secondary importance have also been carried out by the New York Stock Exchange, the National Association of Securities Dealers, and the Investment Bankers Association of America.

While these previous efforts have varied somewhat in the extent of their analysis, their findings have been roughly consistent over time. Briefly, they have indicated that, (1) there has been a growing interest on the part of the investment banking community in obtaining non-cash, equity compensation. This interest has reached a peak, particularly among underwriters dealing in new issues, during periods of speculative excess when "hot issues" were expected to reach a substantial premium over the offering price within a relatively short period of time. This is particularly significant in light of the fact that many managing underwriters know well in advance that they will have no trouble in selling the issue; (2) the incidence of non-cash compensation has been greater among issues of smaller, unseasoned companies than among the larger, more established firms; (3) the use of non-cash extras has not resulted in a lower level of cash commissions paid by the issuer. One does not appear to have been substituted for the other. Those firms paying extra compensation are those also paying the highest levels of cash compensation; (4) there have been acknowledged abuses in the area, but efforts are being

made by regulatory agencies such as the NASD to overcome the difficulties, and, indeed, to reduce the potential value of extras.

RESEARCH DESIGN

The Investment Dealers Digest was selected as the starting point of the investigation. The Digest, in its semi-annual Corporate Financing Directory, compiles information on "all the U. S. corporate financing" accomplished in the previous six month period. The advantages of this tabulation of financing activity are its comprehensiveness and its consistency over time, as well as its explained variation from other sources of similar information.

More than a dozen types of securities offerings were excluded from the study due to the fact that extra compensation was not used in those instances or was not meaningful to the study. Among the categories excluded were "best efforts" offerings, mutual funds, and debt and preferred stock offerings. The remaining offerings, concentrated mainly in the area of new issues of common stock, included the great majority of underwritings with extras, and also provided a workable subset of data. This subset included offerings where secondaries were included as well as shares being issued by the company. (See Table 1)

TABLE 1

"QUALIFIED UNDERWRITINGS", BY YEAR

1965	165
1966	133
1967	224
1968 (six months)	253

The time period from January 1, 1965 through June 30, 1968 was selected for study because of the variety of economic and market conditions that prevailed during that time. It was also felt that enough time had passed since the end of that period that underwriters would have had the opportunity to exercise some of the options they had recieved. Some warrants and options still had some time to run, however. Underwriting activity also varied considerably during the period, but was generally increasing in intensity and the number of issues brought to market. 775 issues were identified in the 42 month period. Of these "qualified" issues, 145 involved the use of non-cash extras in the underwriting compensation.

A questionnaire was sent to the investment bankers who had managed the offering of these 145 issues. Unfortunately, a number of underwriters had suffered business failures, merged with other firms, or were in the process of liquidation. In these instances, information had been lost or was unavailable and reduced the number of responses.

The number of underwriters who had actually disposed of their extras completely was small. In only 15 of the 112 responses had securities been exercised or sold. This was due primarily to the weak stock market conditions that prevailed for much of the period subsequent to 1968. However, when these results were combined with an analysis of the many options that were still held by underwriters, it was concluded that adequate data was available to carry on the intended research. (See Table 2)

TABLE 2

RESPONSE TO MAIL SURVEY OF UNDERWRITERS OF QUALIFIED ISSUES

Disposition of Option	1965	1966	1967	1968	Total
Still Held	0	5	16	39	60
Expired	1	0	1	0	2
Exercised (or sold)	2	5	5	3	15
Data not available#	2	3	8	22	35
Total	5	13	30	64	112
Issues with "extras" (See Table 12)	9	13	38	85	145

#This category includes those issues handled by under writers who were no longer in business, those merged into other firms with a subsequent loss of data, or those firms in the process of being liquidated at the time of the survey.

SURVEY RESULTS

The analysis of the data was broken down into three parts. The first section was essentially descriptive material dealing with all of the qualified underwritings involving extra compensation. Confirmed was the expectation that most of these underwritings would be small. 86% of the offerings with extras grossed amounts of three million dollars or less. Although not normally included in the underwritings, shares represented by extras amounted to a high percentage of the shares actually offered for sale. And, while the initial exercise price of warrants and options were generally well above the public offering price of the securities, the price discounts granted via cheap stock were frequently quite large. The underwriting spread for the period 1965-68 appeared to be somewhat lower than it had been in the earlier studies. (See Tables 3-7)

The second stage of the analysis concerned itself with the various categories of response to the survey. In the first instance, the responses that indicated options were "still held", only 14% would have been profitable if they had been sold as of March 26, 1971. The majority of these warrants were exercisable only at substantial over the then current market price. Only two options had expired as of the dates of the survey.

Examination of those extras that were exercised or sold was again broken down into three sections depending upon the completeness of disposition. The first classification was that where cheap stock had been sold or where warrants were exercised and the underlying shares subsequently sold by the underwriter. (See Table 8)

TABLE 3

SIZE OF UNDERWRITINGS WITH EXTRAS, BY YEAR

Size of Offering	1965		1966		1967		1968		Total	
	#	%	#	%	#	%	#	%	#	%
$10,000,000 and over	-	-	-	-	-	-	-	-	-	-
5.000 to 9.999	1	11	-	-	-	-	3	4	4	3
3.000 to 4.999	-	-	2	15	6	15	7	8	15	10
1.000 to 2.999	8	88	8	61	17	45	33	39	66	45
~~0.500 to~~ 0.999	-	-	-	-	12	31	32	38	44	30
0.300 to 0.499	-	-	3	23	3	8	10	11	16	11
$ 300,000 and under	-	-	-	-	-	-	-	-	-	-
Total[1]	9	100	13	100	38	100	85	100	145	100

[1]Percentages may not add to 100% due to rounding.

TABLE 4

SHARES REPRESENTED BY "EXTRAS" AS A PERCENTAGE OF THE GROSS OFFERING, BY YEAR, 1965-1968

Extra shares as a Percentage of the Gross Offering	1965		1966		1967		1968		Total	
	#	%	#	%	#	%	#	%	#	%
0 - 4%	2	22	2	15	4	10	8	9	16	11
5 - 9%	5	55	7	54	21	55	29	34	62	43
10 - 14%	1	11	3	23	6	16	23	27	33	23
15 - 19	-	-	-	-	4	10	9	10	13	9
20 - 24	1	11	1	7	1	3	8	9	11	8
25 - 29	-	-	-	-	-	-	5	6	5	3
30 -	-	-	-	-	2	5	3	4	5	3
Total[1]	9	100	13	100	38	100	85	100	145	100

[1]Percentages may not add to 100% due to rounding.

TABLE 5

INITIAL EXERCISE PRICE OF WARRANTS OR OPTIONS AS A PERCENTAGE OF THE PUBLIC OFFERING PRICE, BY YEAR

% of the Public Offering Price	1965		1966		1967		1968		Total	
	#	%	#	%	#	%	#	%	#	%
80 - 89%	-	-	-	-	-	-	1	1	1	1
90 - 99	-	-	-	-	-	-	1	1	1	1
100 - 109	6	66	11	92	25	71	44	58	86	65
110 - 119	1	11	1	8	4	11	15	20	21	16
120 - 129	2	22	-	-	5	14	14	18	21	16
130 - 139	-	-	-	-	-	-	-	-	-	-
140 - 149	-	-	-	-	-	-	-	-	-	-
150 -	-	-	-	-	1	3	1	1	2	1
Total[1]	9	100	12	100	35	100	76	100	132	100

[1]Percentages may not add to 100% due to rounding.

TABLE 6

PURCHASE PRICE OF "CHEAP STOCK" AS A PERCENTAGE OF THE PUBLIC OFFERING PRICE, BY YEAR

% of the Public Offering Price	1965		1966		1967		1968		Total	
	#	%	#	%	#	%	#	%	#	%
0 - 9%	-	-	-	-	1	33	2	22	3	23
10 - 19	-	-	1	100	-	-	1	11	2	15
20 - 29	-	-	-	-	1	33	-	-	1	8
30 - 39	-	-	-	-	-	-	3	33	3	23
40 - 49	-	-	-	-	-	-	1	11	1	8
50 - 59	-	-	-	-	-	-	-	-	-	-
60 - 69	-	-	-	-	1	33	1	11	2	15
70 - 79	-	-	-	-	-	-	-	-	-	-
80 - 89	-	-	-	-	-	-	1	11	1	8
Total[1]	0	0	1	100	3	100	9	100	13	100

[1]Percentages may not add to 100% due to rounding

TABLE 7

UNDERWRITING "SPREAD" AS A PERCENTAGE OF THE PUBLIC OFFERING PRICE FOR ISSUES WITH EXTRAS, BY YEAR

Under-writing "Spread" (%)	1965		1966		1967		1968		Total	
	#	%	#	%	#	%	#	%	#	%
6.0-6.9	-	-	-	-	-	-	1	1	1	1
7.0-7.9	-	-	-	-	6	16	5	6	11	8
8.0-8.9	5	56	8	62	10	26	29	34	52	36
9.0-9.9	1	11	2	15	9	24	9	10	21	14
10.0-10.9	3	33	3	23	13	34	37	44	56	38
11.0-11.9	-	-	-	-	-	-	2	2	2	1
12.0-12.9	-	-	-	-	-	-	1	1	1	1
13.0-13.9	-	-	-	-	-	-	1	1	1	1
Total[1]	9	100	13	100	38	100	85	100	145	100

[1]Percentages may not add to 100% due to rounding.

TABLE 8

COMPARISON OF UNDERWRITERS "SPREAD" VERSUS EXTRA COMPENSATION

Under-writing[a]	Gross Spread	"Extra" Proceeds	Proceeds/ Spread
1	$ 260,700	$ 2,503,125	960.1%
2	188,600	175,000	92.8
3	115,500	242,500	209.9
4	306,000	500,000	163.4
5	145,000	460,000	317.2
6	253,000	585,000	231.2
7*	220,000	41,888	19.0
8	216,000	6,750	3.1
9*	101,250	6,600	6.5
10	401,000	73,500	18.3

[a]Much of the information gained from underwriters involved in this study was obtained by a guarantee of anonymity. Assurances were given by the author that neither the names of individual underwriters or their clients would be disclosed.

(*) indicates cheap stock

While profits gained from extras in each of the ten situations in this group were large in comparison with the cost of shares, it must be remembered that these ten were taken from 145 qualified issues and that the qualified group' represented only a fraction of the several hundred issues of common stock underwritten during the period.

A second category included two instances where warrants had been sold by the underwriter as warrants and not exercised. Profits from these two cases were large considering the fact that the initial investment in the warrants was very small. Total compensation received by the underwriter was a high percentage of the gross offering, and, in one case, almost equalled the proceeds received by the issuing firm.

The final sub-category under exercised involved three underwritings where the investment banker had exercised an option or warrants, but was still holding the underlying shares. Profits and degree of total compensation were difficult to judge in these situations due to the difficulty of obtaining information on the eventual disposition of some of these shares, and the fact that these files are still "open" or incomplete until the shares are sold.

Finally, an analysis was made of the different characteristics of the issues comparing the 1965-68 period with earlier data as well as comparing each of the years from 1965 through

1968. The characteristics that were analyzed were underwriting "spread", extra shares as a percentage of the number of shares in the gross offering, and underwriting spread for issues with and without extra compensation.

The device used to test these characteristics was a "t"-test applied to the means of the data for the various years. In only one of the tests for any of the characteristics was a significant difference found to exist among the data. This occurred when comparing the mean underwriting spread for a group of 1965 issues without extra compensation with the 1968 group that included non-cash extras. All other tests of these characteristics failed to show a significant difference, indicating little change in the underwriting process, at least insofar as these characteristics were concerned.

Conclusions

One of the first things that might be learned from this study is that non-cash underwriting compensation is indeed a cyclical phenomenon in the securities markets. Its use is expanded during those periods of acknowledged speculation when the supply of new issues does not seem sufficient to satisfy the demands of investors and these shares are expected to reach quick premiums over their issue price. The practice of issuing warrants and cheap stock declines markedly, however, in slack periods when there are few new issues and those mainly of a more stable, mature character. As one would expect the basic nature of securities trading to remain the same, then one could also expect that the use of extra compensation would continue to display its historic pattern.

Whether non-cash extras are a frequent occurrence or not is also influenced by economic and behavioral factors that are a part of the relationship between the underwriter and the issuer. Certainly no one is more anxious to receive the proceeds of an offering than the issuer. These funds may be critical to expansion or continued operation of his business. In the case of most new issues of common stock, this is the company's first experience with the capital markets. The combination of lack of expertise and the pressure for new funds may make it all too easy for the issuer to sweeten the pot for the underwriter without giving much thought to the implications

for the future financing of the firm and the possible effects on the company's earnings per share. The underwriter, on the other hand, can hardly view each potential offering with the same degree of importance as the issuer. He can be more detached and try to strike a harder bargain with the issuer. He has the advantage of being experienced in an area where the issuer may be a novice.

This view of the underwriting relationship, one that tends to view the situation as a power relationship or a game between adversaries, is not the typical one nor the one that is fostered by the brokerage community. A "game theory" approach, however, may better explain the development and continued use of non-cash extras such as securities, refusal rights, and expense allowances. The fact that many forms of compensation exist makes possible the use of many different "strategies" in negotiating the underwriting agreements. It also takes better account of the differences in bargaining posture that exist between the underwriter and the issuer, or at least allows that differences may exist.

Another general conclusion of the study would be that extra compensation is unlikely to be a source of substantial benefit to the underwriter. Given the results of the 145 qualified issues with extras in the 1965-1968 period, only a small percentage of the extras granted during that period were found to be profitable

to the underwriter. In only a few offerings did the extras turn out to be extremely profitable for the underwriter, at least in comparison with the amounts that he received from cash compensation. But while the possibilities of large returns are small, it may be noted that the risks taken by the underwriters are, in some cases, not very great either. The risk of not being able to sell the entire issue at the public offering price may be small for "hot issues", and in all cases the underwriter has advance indications of his clients' interest before he signs the underwriting agreement. Also, the underwriter normally does not have large amounts of money tied up in these extras. The general relationship of risk and return seems to hold in this area as well: low risks do not provide great returns.

One of the purposes of the study was to determine if there were grounds for criticizing underwriters for abuses in the use of extra compensation. On the whole, evidence for such a conclusion appears to be lacking. Underwriters did not consistently benefit to any great degree from the extra compensation that they received. In a few instances huge profits were made from this form of compensation. But, when one considers the results in relation to the large number of underwriters and issuers involved, the experience

does not appear to be more than random.

Certainly the abuses in the area of non-cash extras do not seem to warrant the calls for investigation and the expenditures of resources for additional studies and information that are heard when the securities markets begin to heat up. Looking at the nature of the various extras, it seems clear that cheap stock is the most objectionable. Paying different prices for the same commodity is a situation that offends more than a few individuals. An improvement co ld be made in the whole underwriting process if cheap stock were declared illegal and the use of options and warrants made subject to national regulations similar to those of the Midwest Securities Commissioners. This policy might also be implemented by treating cheap stock much more stringently for income tax purposes, although a simple ban on the device would be more efficient.

The fact that "extras" of any kind exist should in some sense be objectionable, at l ast to government and other regulatory bodies. Why cannot all of the costs of an issue, including a fair profit for the underwriter, be met in the form of cash compensation, even if it represented a high percentage of the gross offering? The fact that these extras are used so widely, especially at certain times, may be some indication that the regulations and standards,

particularly of the NASD, are unrealistic. Realistic or not, when compensation takes complicated forms it becomes more difficult to judge its fairness and reasonableness, and it becomes more difficult, if not impossible, to regulate its use. The NASD might try to discourage the use of these extras by adjusting its "reasonable" levels of cash compensation if need be. Perhaps its standsrds are not diverse enough to evaluate the underwritings of small, unseasoned companies where the underwriter may indeed face unusual risks. In any case, a straightforward treatment of compensation would be much preferred to the circuitous paths that many underwriters now attempt to follow.

FOOTNOTES

[1]This paper is a summary of the author's doctoral dissertation completed at Northwestern University in September, 1971.

[2]U.S., Congress, House, Report of Special Study of Securities Markets of the Securities and Exchange Commission, 88th Congress, 1st Session, April 3, 1963, House Document 95, Part I, Chapter IV.

[3]Irwin Friend et al., Investment Banking and the New Issues Market (Cleveland, Ohio: The World Publishing Company, 1967).